CLFP Recertification | 2023

Hell or High-Water Revisited

Contract Provisions

A fundamental clause of an equipment lease is the "Hell or High-Water" ("HOHW") provision. A HOHW clause acts to irrevocably bind a lessee to its contractual obligations, including payment, under all circumstances. A typical HOHW provision describes an obligation to make payment as being "absolute and unconditional," and includes a waiver of defenses, setoffs and counterclaims to an enforcement action pursued by a contract adversary.

Favorable Court Rulings

Courts have routinely found HOHW provisions to be enforceable in leases, including when a party claims impossibility of performance or frustration of purpose. The rationale for these rulings is that, through the HOHW provision, the parties specifically contracted for the assignment of all risk. These clauses are essential to the equipment leasing industry, especially for lessors offering credit to lessees who otherwise may not qualify.

Article 2A of Uniform Commercial Code (UCC)

In addition to contract law support, Article 2A of the UCC provides similar statutory HOHW protections to Finance Lease lessors. Under Article 2A, "Finance Lease" is defined as a true lease that consists of a three-party transaction in which the lessor does not select, manufacture, or supply the goods, the lessor did not own the goods before the lease, and the lessee either approves the purchase contract or receives warranty and supplier information before signing the lease. Once the lessee accepts the leased goods under a Finance Lease, the lessee is statutorily obligated to perform under that lease "come hell or high-water."

Note on Article 2A Update

Since 2019, a committee has been formulating UCC amendments. This summer, the amendments (with a proposed effective date of January 2025) were approved by the Uniform Law Commission and recommended for enactment in all the states. The amendments include revisions to Article 2A concerning HOHW treatment of a "bundled" transaction (i.e., one involving a lease of goods and a sale, lease, or license of other property or the provision of services). According to the proposed amendments, provided the "bundled" transaction is a Finance Lease, the lessee's promise to perform with respect to either the entire transaction (if the lease of goods were the predominate purpose) or at a minimum the lease portion of the bundled transaction would be statutorily irrevocable and independent upon the lessee's acceptance of the goods.

Wall Street Journal

Despite all the legal protections afforded to our industry by HOHW provisions, a recent Wall Street Journal front page article, entitled "The Hell or High-Water Clause is Tormenting Small Business Owners," may hold a different sway in the court of public opinion. Indeed, this article was very critical of the HOHW treatment of an equipment lease. Further with the ever-extending reach of the Consumer Financial Protection Bureau, lessors need to be more diligent than ever to protect themselves.

Action on Your Part

- Ensure that all conditions precedent (e.g., delivery of the goods) to consummation of the lease are satisfied.
- Even if you believe your lease qualifies as a "Finance Lease" under Article 2A, include a well drafted HOHW clause in your contract. Precise and conspicuous language is critical.
- Evaluate if you, as the lessor, have taken any actions (intentional or otherwise) that a lessee may claim an "excuse" of their performance.
- Conduct a credit assessment to determine the likelihood that the lessee will be able to meet its obligations under the lease, even if the lessee's performance is delayed. If so, a lessor could agree to a forbearance on the lessee's obligation and keep its protection under HOHW.
- If you decide to exercise your any remedies under a lease, make sure that your paperwork is orderly and includes the lease agreement, any mandated notices, and an accurate accounting of amounts due. Better organization on the front end can save time and expenses at the back end.
- Draft future lease agreements with precision and incorporate new Article 2A updates (once finalized and adopted).
- Make sure your actions, policies, documents, and practices reinforce the "commercial" and HOHW nature of the lease.

The concept of HOHW is critical to our industry. Help yourself by ensuring that you take all actions necessary to preserve your rights and remedies when they are needed most.

Sources
WSJ April 15, 2022 & May 6, 2022
Equipment Finance Advisor
Reed Smith Avoiding Unnecessary Disruption
i Global Transportation Finance Newsletter (flippingbook.com)

Section 1071

What it is

Section 1071 of Title 10 of the Dodd-Frank Wall Street Reform and Consumer Protection Act amends the Equal Credit Opportunity Act (ECOA) and requires that any financial institution must inquire during the credit application process whether the applicant is a small business (currently defined as under $5 million annual revenue), minority-owned, or woman-owned. This amendment will define a financial institution as any business that provides financing options to customers.

If the applicant is deemed to fall in one of these categories, the transaction will need to be reported to the Consumer Financial Protection Bureau (CFPB). Most credit transactions are covered, but true leases (as defined by UCC 2(a)), factoring, and trade credit are exempt. It is also proposed that a financial institution that originates at least 25 transactions during each of the preceding two calendar years would be required to report the data elements to the CFPB.

Potential Issues

There are several potential issues which include:

- Even if the applicant declines to provide the demographic information, the financial institution is still required to provide the financial information to the CFPB (e.g.., how much credit was applied for, approved, or declined, etc.).
- If a lender has met with a principal owner of the business, and the owner declines to provide the demographic information, the lender is required to surmise what their ethnicity is based on their appearance or their last name.
- Loan officers must segregate the demographic information from the underwriters unless it is "infeasible" (the test is ambiguous). If it is determined "infeasible," the lender must disclose to all applicants that their demographic information is being shared with the underwriters along with notice that the financial institution may not discriminate on the basis of the disclosed information.
- How to handle incomplete applications from a TPO (Third-Party Originator) or vendor is unclear but the lending entity will be responsible for the reporting to CFPB even if they are not responsible for the initial data collection.
- If a true lease is determined to be a financing agreement at some point, how it will be handled is unclear.

Compliance Deadline

Currently, the CFPB has proposed a compliance deadline of 18 months after the rule is published in its final form. While there is no set date, the final ruling is expected to be published in 2023.

Effect on the Equipment Lease and Finance Industry

- Every lending institution (no matter the size) including Banks, Independents and Captives will be subject to reporting requirements under this ruling. Failure to comply would result in potentially steep penalties.

- Every lending institution will need to have detailed records on how they met and/or worked with their clients to support why they did not surmise an ethnic demographic data point.
- Lending institutions will be required to report this information for all clients, even those who are returning customers and were not subject to this data requirement in the past.
- Credit extensions would not require reporting, however, returning customers with new requests or re-approvals would be subject to reporting.
- Implementation of a process and system that will collect and track the required data, as well as building the required "firewall" for the information, are likely to be time consuming and expensive.

Please keep in mind that this is currently only what is proposed and for the entire document, visit: ***https://files.consumerfinance.gov/f/documents/cfpb_section-1071_nprm_2021-09.pdf***

Supply Chain Issues and Equipment Residual Ramifications

For the last 24 months, many lending institutions have been experiencing unprecedented positive portfolio performance. This has been due, in part, to government injections of cash into the economy as well as the surge of business that resulted from the release of government lockdowns. Now as demand for goods outpaces the available supply, prices are increasing, and inflation is at its highest point in decades. In an effort to cool spending, the Federal Reserve is raising rates and government agencies are consider regulatory changes however the impact of these actions take time. Economic and supply chain conditions continue to persist that will impact credit quality, approval rates, and underwriting criteria, including the estimation of residual values.

Factors affecting the supply chain and inflationary pressures include:

Workforce
- Global lockdowns – layoffs in production created shortages
- This also resulted in a labor shortage when production resumed, with the labor participation rate near lows not seen since the mid 1970's
- Competition for good talent and compensation is on the rise, resulting in salary and benefit costs that are expected to increase well-above historical norms in the next year

Energy
- Spike in fuel prices hitting at a time of increased energy demand due to the economic recovery
- Lack of global refining capacity
- Rising Interest rates used to cool spending
- Creates borrowers' sense of urgency, inflating prices of goods

Geopolitical
In late February 2022 Russia invaded Ukraine, which is a major worldwide producer and exporter of iron ores, semi-conductor grade neon, sun/safflower/cotton-seed oil, wheat, corn, fertilizers, and other products. At the same time, Russia produces one third of the world's supply of palladium which is required for sensor chips and computer memory. Ukraine is also a major supplier to the car parts industry, specifically wiring harnesses used in automotive electrical systems. War related halts in production have had a domino effect in the automotive and many other industries.

Many countries which rely on oil and gas from Russia are no longer purchasing from Russia, resulting in more countries seeking oil and gas from fewer options. This, combined with the lack of other major exports from both Russia and Ukraine leads to higher prices due to the supply/demand imbalance – at least "temporarily".

Manufacturing

- Significant shortage of semiconductor manufacturing capacity
- Relocation of chips from vehicles to electronics such as cell phones and laptops during the pandemic
- Temporary changes in demand magnifies the problem
- Trade disruption and shipping logjams

Shortage of equipment and parts increases prices and results in the increase of collateral and residual values. The supply chain and inflationary pressures are rapidly and significantly increasing the cost of assets. Yet financing inflated values could drive higher losses and lower residual value percentages of original equipment cost in the future. Exceptional portfolio performance could result in creditors relaxing credit and documentation requirements.

A residual value is the estimated future value of an asset, less the cost of disposal, at the end of the lease term and is important and should be considered when making rate calculations. When determining a residual value, it is important to consider the use of the asset, the useful life, as well as anticipated future market conditions, resale value and economic conditions. In the current economic cycle and geopolitical environment, it would be prudent to establish residual values conservatively.

Articles referenced:

https://www.monitordaily.com/news-posts/aicpa-outlook-for-u-s-economytumbles-to-11-year-low-as-fear-of-recession-grows/
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